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SENSITIVE BUT UNCLASSIFIED HANDLE ACCORDINGLY

¶1. (SBU) Summary: Government officials (including newly appointed Finance Minister Chalungphob) and private sector analysts expressed deep concerns about the economy in meetings with visiting US Treasury officials. Growth forecasts for 2007 have recently been revised downward - from 4.5 to 5 percent to 4 to 4.5 percent by government agencies, and to as low as 3 percent by some private sector analysts. Political uncertainty and the poor policy environment have driven consumption and investment to multi-year lows, leaving exports, once again, the main engine of growth for Thailand.

2.(SBU) Many meeting participants shared a view that increased public expenditure to "pump prime" the economy, particularly through expedited implementation of mega-infrastructure projects, would boost growth. However, financing is off-track and bureaucrats are unlikely to expedite their decisions, making mega-infrastructure disbursements unlikely to happen in time to influence 2007's growth results.

¶3. (SBU) Meeting participants shared a common assessment on the need for the Bank of Thailand (BOT) to aggressively cut interest rates. Markets have already priced in a 50-75 bps cut, with some private analysts suggesting a full percentage point cut to 3.75 percent at the BOT's next meeting on April 11. However, it is unclear whether lower interest rates, without a significant improvement in regulatory and policy certainty, will do much to spur investment and growth in a politically chaotic environment.

4.(SBU) On the issue of proposed revisions to the Foreign Business Act (FBA) and of capital controls, meeting participants lacked consensus and were not able to give a clear picture on the direction of these issues. Minimizing the apparent anti-foreign investor aspects of the proposed FBA revisions and lifting of capital controls would be key signals of an improving policy environment and of a receding of anti-foreign sentiments.. End summary.

2007 Growth - Not Looking Good

5.(U) The National Economic and Social Development Board (NESDB), the Thai government's main economic statistics and forecasting body, recently published forecasts for 2007 growth of 4 to 5 percent, warning 4 to 4.5 percent as a more likely scenario. The forecast presumes a recovery in consumption and investments (4 and 4.8

percent growth respectively, from 3.1 and 4.0 percent in 2006) and export growth of 7.9 percent.

¶6. (SBU) NESDB's presumption of consumption and investment recovery in 2007 may be overly optimistic, however, given prospects for continued political disarray in 2007, lack of timely mega-infrastructure disbursements and continued perceptions of anti-foreign investment policies (details in Para. 7). Further, as appreciation pressures on the baht may continue in 2007, export growth may be lower than forecast further denting 2007's growth. The economy's high dependence on exports (gross exports is 65 to 70 percent of economy, two times the regional average) makes it susceptible to any slowdown in export growth.

¶7. (SBU) Political uncertainty has been the main factor driving private investment and consumption to multiyear lows. Thailand's private investment activity index fell 0.6% y/y in January, the first negative reading of the indicator since February 2002. Private consumption's fourth quarter growth of 2.5 percent was the lowest since 1999. Total domestic sales of pickup trucks, a key leading indicator, in January to Februrary fell 28 percent from the same period a year ago and total vehicle output is down 3.3 percent. Citigroup forecasts Thai listed firms to average 3 percent earnings growth for this and next year, compared to Asia ex-Japan of 13 percent.

¶8. (SBU) While growth was a respectable 5 percent in 2006, this number hides the significant decline in growth over the course of the year. The fourth quarter saw the weakest results for the Thai economy in two years, notably in private investment and consumption which fell from 4 percent growth each in the first quarter to 2.3 to 2.5 percent, respectively, in the final quarter. In its survey of listed companies, Citigroup found net profits of non-financial companies down by 56 percent y/y in the final quarter of 2006. The

combined profit of 46 of the 50 biggest publicly traded companies by value dropped 70 percent in the fourth quarter of 2006, compared to a year earlier.
9.(SBU) On export growth, NESDB's target appears achievable; exports rose 18 percent y/y in January, despite a 13 percent y/y appreciation of the baht. And the government is fiscally strong, with low debt and predominantly fiscal surpluses over the past few years. Finally corporate balance sheets are strong and high leverage not a concern for the economy. However, downside risks remain. Tourism, which contributes to approximately 7 to 8 percent of GDP, has remained surprisingly resilient in the face of September's coup and January's Bangkok bombing. Thus far, political unrest has mainly affected domestic consumption and investment. Should violence spread beyond the three southern provinces, the impact on tourism and the general economic climate will see GDP growth fall lower than the bottom-range of current forecasts.

10.(SBU) Government officials and market participants are calling on the BOT to aggressively cut interest rates, with some suggesting a full percentage point cut to 3.75% at the next monetary policy committee meeting on April 11. Inflation is clearly on a downward trend (BOT forecasts 2007 inflation of 1.5 - 2.5 percent, down from 2006's inflation of 4.7 percent) leaving room for aggressive cuts. However, interest rate cuts may not be enough to boost growth. BOT's benchmark rate mainly affects bond markets which account for only 15 percent of corporate funding. The remainder of funding for Thai companies comes from commercial banks loans, and these are priced off the Thai equivalent of prime rate (currently 7.25 percent) and lags policy rates. Further, it is unclear whether lower interest rates, without a significant improvement in policy certainty, will do much for growth in a politically chaotic environment. Anecdotally, companies and analysts with whom we speak all say that they want to wait "until after the elections" before making any significant new investments. The Japanese economic counselor related that Japanese companies are inclined to wait "at least one more year, to see how things go" before adding new capacity in Thailand.

Attempts to Pump Prime the Economy - the Mega-Projects
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¶11. (SBU) The Ministry of Finance (MOF) has forecast that in order to reach 4.5 percent growth, government and state-owned enterprises (SOEs) will have to spend 93 and 83 percent, respectively, of their FY07 budget (ending in September). With the approval of the FY07 budget delayed by three months due to the September coup, full disbursements for the fiscal year began only in February 2007. With the government now having only 9 months to disburse an amount that normally takes 12 months, senior staff in the MOF's fiscal policy office expressed some concern that they will not meet their targets. MOF staff noted that Thailand historically disburses an average 92 percent of its annual budget over a full fiscal year.

¶12. (SBU) To reach these targets, officials have hinged their hopes on rapid implementation of two of Thailand's mega-infrastructure projects. The MOF is waiting for the Japan Bank for International Cooperation (JBIC, a hybrid governmental financing agency mixing Ex-Im and USAID-like functions) to approve a loan for initial financing for both. However, as related in reftel, former Deputy Prime Minister Somkid who has close relations with Japanese investors, indicated that JBIC will not be funding these projects. The Japanese economic counselor effectively confirmed this information. JBIC, as embassy has repeatedly heard from other foreign investors, is not increasing its exposure in Thailand due to the uncertain political situation and anti-foreign sentiments.

FBA Revisions and Capital Controls - What Next?
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¶13. (SBU) Government officials' sentiments on capital controls appear to be slightly contradictory. Officials and market participants were painfully aware of the negative toll capital controls (and proposed FBA revisions) have taken on the markets and investor sentiment. Given the weak domestic economy, both officials and market participants were sensitive to the need to support export growth, in part by keeping the baht weak. The Federation of Thai industries (FTI) is forcefully advocating for continued controls, but there appears to be no well-organized advocacy group(s) willing to publicly argue against controls or highlighting the negative implications of controls for Thailand. (Currently the 30 percent reserve requirement applies only to non-hedged investments in bonds, mutual funds, real estate funds, and foreign currency loans.)

Further there is no open debate to exporter's assertion that continued appreciation will hurt their growth (as noted earlier, exports grew 17 percent y/y in January despite appreciating baht) or that exporters should hedge and manage their own exchange rate risk. This is attributed to the recognition of exports as the key sector of the Thai economy and the unwillingness of the financial sector to criticize policies believed to benefit the real sector.

¶14. (SBU) Yet, as of three months after imposition of capital controls, Thailand continues to face strong appreciation pressures. Whereas the BOT had targeted capital controls to "get foreign speculators" appreciation pressures since the beginning of the year have been due predominantly to high net export earnings. In the past, exporters' demand to purchase baht (Thai regulations limit the number of days before exporters must convert foreign exchange earnings into baht) had been relatively balanced by importer's demand to sell baht. However, with depressed domestic demand, imports have greatly reduced. Thus Thailand finds itself in an unintended situation of depressed economic prospects with appreciation pressures on the baht from its own exporters. Septel will examine the issue of baht appreciation and capital controls in detail.

15, (SBU) As noted in reftel, Finance Minister Chalungphob has stated he will keep some form of capital controls in place, but stressed that they will be "appropriate," not "shock markets" and will be used as a tool to manage "market psychology." Analysts believe that Chalungphob is trying to find middle ground, to cast his capital controls in a more market friendly light.

16.(SBU) On FBA revisions, while aware of its negative market impact, officials were not able to offer a good sense of where this

issue may be heading, but were able only to point to the strong political motivations behind the revisions - the need to "nab-Thaksin" by targeting his sale of Shin Corp to Singapore's Temasek. Finance Minister Chalungphob stated boosting investor confidence, particularly foreign investor confidence, would be a priority for his tenure. He told us that the current FBA draft is "too broad" and the telecom sector should be the only one under consideration currently since it is an area deemed to be of national security and was the original case of the entire FBA amendment effort due to the Shin Corp-Temasek transaction (reftel). However, FBA revisions fall outside his portfolio and so he will have to influence others rather than directly administer his vision.

¶17. (SBU) Comment: While concern about economic growth is deep and wide, prospects for a strong policy response to boost growth are dim. The political leadership is still uncoordinated and civil servants are reluctant to make firm decisions under the interim (and increasingly unpopular) government. Deputy Prime Minister for Economy (excepting Finance) Kosit this month set up an economic committee to guide economic policy, but its effectiveness and direction remains to be seen; it's first meeting was held last week.

¶18. (SBU) Further, the contradictory responses to capital controls and FBA revisions by meeting participants reveal the lack of policy debate in the current politically incoherent environment. Minimizing the anti-foreign investor aspects of FBA revisions and lifting of capital controls would be key signals that the regulatory bias against foreign investment is lessening and could give a boost to lackluster investment and consumption activity.

¶19. (SBU) However, political uncertainty remains a dark cloud that hangs over all activities. Two key private sector meeting participants noted that the release of the first draft of the new constitution (scheduled for April 19) will be a major event that will determine the political (and thus economic) stability for Thailand for the near term. Pro and anti-government groups are currently fiercely debating provisions for the constitution. The first draft of the constitution will either alleviate or only further exacerbate political tension.
Boyce